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Daniel J. Flanigan (DF-6929)
Eric C. Andrews (EA-8212)
POLSINELLI, WHITE, VARDEMAN & SHALTON
A PROFESSIONAL CORPORATION
700 West 47th Street, Suite 1000
Kansas City, Missouri 64112
Tel: (816) 753-1000

George R. Hirsch (GH-8284)
BRESSLER, AMERY & ROSS
A PROFESSIONAL CORPORATION
17 State Street
New York, NY 10004
Tel: (212) 425-9300

ATTORNEYS FOR SECURITY BANK OF KANSAS CITY

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:)	
)	
Randall's Island Family Golf Centers, Inc.,)	Chapter 11
<u>et al.</u>,)	
)	Case No.: 00-41065
Debtors,)	Through 00-41196 (smb)
)	

**MEMORANDUM OF LAW IN SUPPORT OF
MOTION FOR RELIEF FROM AUTOMATIC STAY
AND FOR MODIFICATION OF CASH MANAGEMENT ORDER**

TO THE HONORABLE JUDGES OF THE UNITED STATES BANKRUPTCY COURT FOR
THE SOUTHERN DISTRICT OF NEW YORK:

This Memorandum of Law is filed in support of the Motion For Relief From Automatic Stay ("Motion") of Security Bank of Kansas City (the "Bank") filed contemporaneously herewith.

All terms defined in the Motion will have identical meanings when used herein.

Summary of Pertinent Facts

The facts, which are set forth in detail in the Motion, are straightforward. The Bank holds a first priority mortgage and security interest in all real and personal property of Blue Eagle (OP) and the proceeds, products, rents, and profits thereof. Blue Eagle (OP) failed to pay its May 2000 payment due under the loan documents. The fiduciaries in control of the Blue Eagle (OP) bankruptcy estate have failed to segregate the Bank's cash collateral and have diverted funds of the Blue Eagle (OP) bankruptcy estate to and for the benefit of other affiliated Debtors' bankruptcy estates. The funds generated by Blue Eagle (OP) are not being applied to the Bank's debt service and are part of a pool of funds that is being used among other things to service the Chase syndicate's second mortgage debt on the property and for the benefit of Blue Eagle (OP)'s shareholders and corporate affiliates.

Argument

I. The Cash Management Order, Which Diverts The Funds Of The Blue Eagle (OP) Estate For The Benefit Of Other Bankruptcy Estates And Their Creditors, Effectuates An Unlawful De Facto Substantive Consolidation Of The Affiliated Estates Without Due Process.

The Cash Management Order is a wolf in sheep's clothing, effectuating a substantive consolidation and an elaborate DIP financing scheme under the guise of a non-substantive, administrative order entered on an essentially ex parte basis. The deceptive emphasis on administrative convenience and pre-bankruptcy ordinary course dealings completely ignores the separate legal identity of the individual Chapter 11 Debtors and their separate assets and liabilities and the right of the creditors of those estates to look to those separate assets free from diversions for the benefit of affiliated Debtors and their creditors. The directors, officers, and counsel, of and for Blue Eagle (OP) have fiduciary duties to the Blue Eagle (OP) estate, and there has been

no showing that the Blue Eagle (OP) estate will benefit from the Cash Management Order or the proposed DIP financing from the Chase syndicate to and for which so much is being sacrificed. In fact, outside of bankruptcy, the contemplated transfers would easily and at once be recognized for what they are—transfers for no value to Blue Eagle (OP), i.e. fraudulent transfers.

The fiduciaries currently in control of the Blue Eagle (OP) estate are treating the jointly administered Debtors as a collective entity to the detriment of Blue Eagle (OP). Such a system is likely to benefit “weak sister” Debtors and their creditors at the expense of more financially sound Debtors and their creditors and to support a parent organization that is of no earthly benefit and, in fact, has been and continues to be a parasitical detriment to the efficient and effective operation of the Blue Eagle (OP) facility. Indeed, this parent entity has been a virtual “black hole” that has consumed \$130 million in Chase syndicate funds and \$115 million in bondholder funds in the last few years with only this Chapter 11 to show for its efforts.

The fiduciaries and others currently in control of this bankruptcy have no incentive whatsoever to protect the separate interests of the Blue Eagle (OP) estate—not the parent or its directors and officers whose interest is in trying to somehow salvage the collective enterprise—not the omnibus Creditors Committee that is composed largely of creditors who have extended credit to Debtors other than Blue Eagle (OP). At least some if not all of the creditors represented on the Committee, such as the bondholders, have already gambled their own money and lost it and now have no incentive to do anything other than to try to recover some of their losses by gambling other people’s money. Neither does the Chase syndicate, whose prepetition \$130 million claim appears to be substantially undersecured and whose risk on the DIP financing appears to be nil, have any interest in doing anything other than utilizing the separate assets of Blue Eagle (OP) to shore up the syndicate’s prepetition undersecured position.

Effectively, although the Debtors fail to disclose it, any transfer of Blue Eagle (OP)'s funds into a centralized cash management system is, at best, a loan to the other entities, at worst a simple fraudulent transfer. Clearly, in an individual Chapter 11 case, where a debtor's affiliates had not filed bankruptcy petitions, a court would not permit the debtor to make loans or other transfers to those affiliates—probably at all—but certainly not without proper notice, hearing, and very detailed investigation and a very strong showing with respect to the credit-worthiness of the transferee and the reasons for such transfer and, presumably, also with respect to the loan terms, security, etc. Certainly then, these fiduciaries should not be allowed to blithely effectuate such an arrangement with the affiliates in bankruptcy, with none of these safeguards, through the horribly misnamed cash management system.

Moreover, the operation of the system as proposed creates irreconcilable conflicts of interest for the Debtors, the officers and directors of each individual Debtor, the omnibus Creditors Committee, the DIP lender, and the Debtors' and Committee's attorneys, accountants and financial advisors. Although their fiduciary duty requires these people to consider the best interests of the creditors of each individual estate, the centralized cash management system contemplates that decisions will be made, at best, on behalf of the collective Debtors and, at worst, on behalf of the parent and other of the weakest, most parasitical of the affiliated group.

The Cash Management Order accomplishes a de facto substantive consolidation of the Debtors' estates without even attempting to satisfy the stringent requirements that must be met before substantive consolidation is imposed. As the Second Circuit stated in the leading case of Union Savings Bank v. Augie/Restivo Baking Company, Ltd. (In re Augie/Restivo Baking Company, Ltd.), 860 F.2d 515, 518 (2nd Cir. 1988), “the sole purpose of substantive

consolidation is to ensure the equitable treatment of all creditors.” In finding that substantive consolidation was not warranted in the case before it, the Second Circuit stated:

“creditors who make loans on the basis of the financial status of a separate entity expect to be able to look to the assets of their particular borrower for satisfaction of that loan. Such lenders structure their loans according to their expectations regarding that borrower and do not anticipate either having the assets of a more sound company available in the case of insolvency or having the creditors of a less sound debtor compete for the borrower’s assets. Such expectations create significant equities.”

Id. at 518-519.

The Bank certainly did not make its loan to Blue Eagle (OP) on the basis of the collective Debtors. Indeed, the “Family Golf” group was not even involved in the transaction. It is inequitable in the extreme for the Bank to have the funds on which it counted for repayment of its debt thrown into a pool for use in propping up an ill conceived roll-up scheme implemented after the Bank made its loan.

Without saying so, the fiduciaries currently in control of this bankruptcy are proposing to embark on an obviously unlawful enterprise exactly like the one condemned in In re Helms, 48 B.R. 714 (Bankr. D. Conn. 1985). In Helms the trustees of the estates of affiliated debtors sought the Court’s authorization to administer property of the related debtors “without regard to whether particular property is property of any particular estate. The trustees also seek authorization for the professional persons retained by the trustees to apply for compensation from the [related debtors’] estates or the estate of any related debtor regardless of which estate the services were rendered to.” (at 715-716) But the court would not “permit the merger of assets at the expense of the legitimate rights and claims of identifiable creditors” and further stated (at 716):

“In deciding whether substantive consolidation would be appropriate in a given case, an important factor would be whether there are creditors who have treated one debtor as a distinct and separate entity. Under those circumstances, substantive consolidation would not be allowed as that result would be manifestly prejudicial to such creditors. In re Food Fair, Inc., 10 B.R. 123 (Bankr.S.D.N.Y.1981), *citing* Chemical Bank vs. Kheel, 369 F.2d 845 (2d Cir. 1966). . . . I cannot . . . permit the trustees to deplete the assets of some estates in an attempt to locate and acquire funds for the benefit of creditors of other estates, particularly as the trustees have failed to demonstrate that such an exploration will achieve a net benefit for the unsecured creditors of any estate. Put another way, if the motion were to succeed, the trustees could force the creditors of some estates to fund a search for assets of other estates without assurance that the funding creditors would participate in any recovery. Such a result should not be permitted in a court of equity.”

II. Cash Collateral Or Other Funds Of A Bankruptcy Estate Cannot Be Used To Pay A Second Mortgage Holder (Or, By Implication, A Shareholder Or Other Equity Owner) Of The Debtor Unless The First Mortgage Holder Is Receiving Its Debt Service

In In re Realty Southwest Associates, 140 B.R. 360, 366 (Bankr. S.D.N.Y. 1992), *citing* In re Vienna Park Properties, 136 B.R. 43, 53-54 (S.D.N.Y. 1992), the Court rejected the debtor’s attempt to use monies generated from the debtor’s operations to service debt on a second mortgage while withholding payments from the first mortgagee. 140 B.R. at 366. The instant case presents an even worse nightmare for the first mortgage holder. Not only will some of the funds from Blue Eagle (OP)’s estate be part of the “pot” that will be used to pay debt service on the DIP lender’s new second mortgage, which was condemned in Realty Southwest; but presumably, at least the second mortgagee in Realty Southwest had provided funds that benefited that debtor as opposed to its parent and brother-sister entities, whereas here the proceeds of the DIP second mortgage loan would appear to be of no benefit whatsoever to Blue Eagle (OP), its property, or its creditors (other than the Chase syndicate itself as the holder of a guaranty from Blue Eagle (OP) of its parent’s debt that was a fraudulent transfer when made). Even worse, here the monies being siphoned from this estate are being used for the primary

benefit not of a creditor at all but of a shareholder (the parent) and even total interlopers (the brother-sister affiliates).

III. The Debtor Has Failed To Segregate Cash Collateral

The detrimental effect on the Bank of the Cash Management Order is compounded by the Debtors' failure to comply with the fundamental requirement of Section 363(c)(4) that cash collateral be segregated. The Bank has a perfected security interest in inventory. The Debtor obtains substantial revenues from sales of pro shop merchandise, food and beverage, and vending machine inventory. There can be no justification whatsoever for failing to segregate these proceeds and Debtor's failure to do so can only be characterized as, at best, willfully obtuse.

The Bank's collateral extends to and includes every conceivable type of real or personal property. For example, Section 3.01 of the Mortgage contains an absolute assignment of "all rents, income, profits, proceeds and any and all cash collateral to be derived from the Premises or the use and occupation thereof . . . including all rents, royalties, revenue, rights, deposits (including security deposits) . . . and the right to receive the same and apply them against the Obligations or against Grantor's other obligations hereunder, together with all contracts, bonds, leases and other documents evidencing the same now or hereafter in effect and all rights of Grantor thereunder." Thus, all or substantially all income from the facility other than inventory sales, including from the driving range and miniature golf, is cash collateral--either as "rents" of the Bank's real or personal property collateral under 552(b)(2) or as "proceeds, products, offspring, rents, or profits" under Section 552(b)(1). Until the Bank's rights are determined, the Debtor should not be allowed to assume that the Debtor's legal position is infallibly correct and ignore Section 363(c)(4) by pouring these funds down a black hole, rendering them possibly untraceable and leaving the Bank with no recourse.

The Debtors have stated in their pleadings that the Bank and other non-Chase lenders are oversecured. However, the Debtors have not established their burden to show that any equity cushion is sufficient to allow funds of the Blue Eagle (OP) estate to be used for the benefit of other entities. See In re 680 Fifth Ave. Associates, 154 B.R. 38, 43 (Bankr.S.D.N.Y. 1993). Even if the Bank is oversecured, it is improper to authorize “a distribution of estate property to nondebtors [as in the instant case, the distribution was to equity owners of the debtor] ahead of secured creditors.” In the Matter of Plaza Family Partnership, 95 B.R. 166, 174 (Bankr. E.D. Cal 1989). “The effect of such a use would be to subordinate secured claims to the claims of the debtor and others. Such a result is inconsistent with the intent and purpose of the bankruptcy code.” Id. See also In re Morning Star Ranch Resorts, 64 B.R. 818 (Bankr. D. Col. 1986). Of course, it goes without saying that this is true whether or not the funds in question are, technically, cash collateral. In re Hall Elmtree Associates, Ltd., 126 B.R. 73 (Bankr. D. Az. 1991).

IV. The Debtor Has Failed To Pay Real Estate Taxes

Blue Eagle (OP) has already failed to pay or make provisions for the payment of real estate taxes in the amount of \$74,435.21 for the first half of 1999. If Blue Eagle (OP) continues to fail to pay taxes, such accrued taxes will injure the Bank, priming its lien and necessarily effecting a reduction in the value of its lien. The Bank has already been injured to the extent of the unpaid 1999 taxes.

Conclusion

Accordingly, the Bank believes that the Court should enter an Order modifying the automatic stay for the purpose of allowing the Bank to enforce its lien, mortgage and security interests against Blue Eagle (OP) and all property of Blue Eagle (OP) in or on which the Bank has

a lien, mortgage, or security interest; modifying the Cash Management Order to provide that all funds generated by or at the Blue Eagle (OP) facility and the Blue Eagle (OP) bankruptcy estate on hand as of the Filing Date or generated thereafter shall be returned to the Blue Eagle (OP) estate and that all future funds generated by or at the facility shall be segregated for the benefit of the Blue Eagle (OP) Estate; requiring that the Debtor segregate and account for all cash collateral of the Bank on hand as of the filing of Blue Eagle (OP)'s bankruptcy petition or that was generated by or at the facility thereafter; and granting such other and further relief as is just and proper under the circumstances.

Dated: May 24, 2000

POLSINELLI, WHITE, VARDEMAN & SHALTON
A PROFESSIONAL CORPORATION

By: /s/ Daniel J. Flanigan
Daniel J. Flanigan (DF-6929)
Eric C. Andrews (EA-8212)
700 West 47th Street, Suite 1000
Kansas City, Missouri 64112
(813) 753-1000

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CITY

Exhibits To This Pleading To Be Separately Scanned